No. 10198

In the United States Circuit Court of Appeals for the Ninth Circuit

Consolidated Choliar Gould & Savage Mining Company, a Corporation, petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the United States Board of Tax Appeals (R. 71–79) is reported at 46 B. T. A. 241.

JURISDICTION

This appeal involves income taxes for the calendar years 1936 and 1938. The notice of deficiency for the year 1936 is dated May 14, 1940 (R. 11), and the taxpayer's petition for redetermination was filed with the Board of Tax Appeals on August 10, 1940 (R. 1). The notice of deficiency for the year 1938 is dated July 11, 1940 (R. 25), and the taxpayer's petition for redetermination was filed on October 7, 1940

(R. 3). The jurisdiction of the Board of Tax Appeals rests upon Section 871 of the Internal Revenue Code. The decisions of the Board were entered on March 25, 1942 (R. 80, 81), and the petition for review by this Court was filed on June 24, 1942 (R. 82–87). The jurisdiction of this Court rests upon Sections 1141–1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the taxpayer is entitled, under Sections 23 (m) and 114 (b) (4) of the Revenue Acts of 1936 and 1938, to deduct percentage depletion in respect of income derived during the tax years 1936 and 1938 from the extraction of gold from previously unmilled low-grade ores produced by others from mines on their properties and deposited and dumped by them upon the land of the taxpayer's predecessor in title.

STATUTES AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra*.

STATEMENT

The facts as found by the Board (R. 72–75) may be summarized as follows:

The taxpayer, a California corporation having its principal office at San Francisco, California (R. 72), acquired by purchase in 1933 the so-called American Flat property near Virginia City, Nevada, and during the years in issue owned the property in fee (R. 73). Prior to such purchase and between the years 1872 and 1898 the owners of neighboring mining properties had transported and dumped unmilled low-grade ore material from their mines, which they considered to be

waste, upon the American Flat property, then owned by the Overman Mining Company. (R. 73–74. See also R. 51–53.) The Overman Mining Company allowed them that privilege, but at the time such materials were dumped on Overman's property it was considered that the Overman Company thereby became the owner of those materials. (R. 74.)

Taxpayer erected a mill in 1934 about 2,000 feet from the dumps, and began processing the material in them. (R. 56–57, 75.) The ore materials were removed from the dumps to the mill, for processing, by use of a power shovel and trucks. The dumps in question did not constitute mines. (R. 75.)

In reporting its taxable income for the years in issue the taxpayer claimed percentage depletion upon its gross income from processing the material in the dumps. The Commissioner of Internal Revenue ruled that the dumps did not constitute mines or other natural deposits within the meaning of Section 23(m), disallowed the claimed deductions for percentage depletion with respect to the gross income derived from processing the material in the dumps, and determined deficiencies accordingly. (R. 13–16, 25–29.) The Board of Tax Appeals sustained the Commissioner's determination. (R. 71–79.)

SUMMARY OF ARGUMENT

The taxpayer is not entitled to percentage depletion upon the gross income realized from the processing of the abandoned rock dumps. Those dumps did not constitute mines or natural deposits within the ordinary meaning of those words. The controlling factor

is that the dumps were not the product of the taxpayer's land, but were the product of neighboring lands. As in the case of tailings, the dumps were the residue of an older, less efficient method of treating the product of a mine.

The instant case not only falls without the plain meaning of the statutory provisions granting the depletion deduction, but is also outside of the underlying principle upon which the deduction is based. That underlying principle is to compensate for the severance and disposition of part of the substance of the land. Here the properties which suffered depletion were the neighboring mines from which the ore had been extracted. The plain fact of the matter is that when the taxpayer worked the dumps in question it was engaged in processing, not in mining.

ARGUMENT

The taxpayer is not entitled to percentage depletion in respect of its gross income from the extraction of gold from the abandoned rock dumps of neighboring producers

Section 23(m) of the Revenue Acts of 1936 and 1938 (Appendix, *infra*) allows a deduction from gross income for depletion "In the case of mines, oil and gas wells, other natural deposits, and timber." And Section 114(b)(4) permits a taxpayer to compute the depletion allowance upon the basis of a percentage of the gross income from the property during the taxable year. In approaching the issue presented in the instant case, it is important to note that since the above sections are ones granting a deduction, they must be

strictly construed and the taxpayer must be able to show that he comes clearly within their terms. *Nevada-Massachusetts Co.* v. *Commissioner,* 128 F. 2d 347 (C. C. A. 9th), and cases there cited.

We agree with the taxpayer that the only issue requiring decision in the instant case is whether the abandoned dumps of rock which had been deposited by neighboring producers upon the land now owned by the taxpayer constituted mines or other natural deposits within the meaning of Section 23(m).

It is the Government's position that under no construction of the statute, and certainly not under the strict construction which is required, may these dumps be held to constitute mines or other natural deposits. It is fundamental that the term "mines" is to be given its ordinary meaning in the construction of the section in question. *Ozark Chemical Co.* v. *Jones,* 125 F. 2d 1 (C. C. A. 10th), certiorari denied, June 1, 1942.[1] The term "mine" is defined in Webster's New International Dictionary (1933) as "A subterranean cavity or passage; esp.: *a* A pit or excavation in the earth, from which ores, precious stones, coal, or other mineral substances are taken by digging; as, a gold *mine;* an asphalt *mine;* * * *." In Bouvier's Law Dictionary (Rawle's Third Rev.) a mine is defined as an excavation in the earth for the purpose of obtaining minerals. Similar definitions are to be found in

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[1] See also *Helvering* v. *Hutchings*, 312 U. S. 393; *Magnano Co.* v. *Hamilton*, 292 U. S. 40, 46; *Avery* v. *Commissioner*, 292 U. S. 210; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 327; *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 560; *DeGanay* v. *Lederer*, 250 U. S. 376.

Black's Law Dictionary (Third ed.), in Lindley On Mines (Third ed.), Secs. 88–89, and in White, Mines and Mining Injuries, Law (1903), Secs. 1–2. These authorities point out that the term was apparently derived from the Latin word *minare* signifying a subterranean passage.

A similar definition was used to test the meaning of the term in the very sections here under consideration in *Atlas Milling Co.* v. *Jones,* 115 F. 2d 61 (C. C. A. 10th), certiorari denied, 312 U. S. 686, in which the court said (p. 63):

> A "mine" is an excavation in the earth from which ores, coal, or other mineral substances are removed by digging or other mining methods. In its broader sense it denotes the vein, lode, or deposit of minerals. Mining connotes the removal of minerals from a natural deposit.

The *Atlas* case held that a deposit of tailings did not constitute a mine within the meaning of the sections here involved and that holding was approved by this Court in *Commissioner* v. *Kennedy Min. & M. Co.,* 125 F. 2d 399. See also *Britt* v. *Commissioner,* 43 B. T. A. 254. We submit that the instant case is governed by the decision in the *Atlas* case. The taxpayer has attempted to distinguish the *Atlas* case on the ground that there is a difference between a deposit of tailings and the dumps of rock here involved. That that distinction is without merit is clearly indicated by the opinion in the *Kennedy* case, *supra.* Both tailings and rocks such as are here involved were originally products of a mine. Both are ores contain-

ing minerals. It is immaterial that in one case some of the minerals have already been removed. Insofar as any mineral remains in the tailings, it is there in exactly the same state in which it is present in rocks which have not yet undergone any treatment. Both are the residue of an older, less efficient method of treating the product of a mine. The controlling factor in both the *Atlas* and the case *sub judice* is that the deposits represented the product of other lands. This is clearly brought out by the decision in the ***Kennedy*** case, *supra*. That case involved the reworking of tailings *by the mine owner*. The tailings in question represented the product of a mine upon the taxpayer's land. It was held that the taxpayer there was entitled to a depletion deduction with respect to the income derived from the reworking of the tailings because that income came from ores which had been taken from the taxpayer's mine. It was pointed out that it was immaterial that the ores had been removed from the mine in prior years since several years may elapse between the removal of the ores from the earth and the final sale of the metal in the normal course of mining. The *Atlas* case, *supra,* was distinguished on the ground that the person who reworked the tailings there was not the owner of the mine from which the tailings had come. That is exactly the situation in the instant case.

The taxpayer argues that the dumps in question were a part of the realty purchased and owned by it. We do not believe it important to determine whether under the law of Nevada these rocks might have been

held to be realty for some purposes. The rocks undoubtedly became personal property when they were extracted from the neighboring land. See the *Atlas* case, *supra,* at page 63, and cases there cited. Whether or not when those rocks were placed on the land which the taxpayer now owns they became a part of the realty in the sense that they would pass with a conveyance of land is wholly immaterial.[2] Those rocks clearly did not become a mine any more than a building erected on a plot of land is a mine although undoubtedly it would pass with a conveyance of the land.

The words "other natural deposits" in Section 23(m) support rather than refute the Government's position in the instant case. By "natural deposits" Congress undoubtedly meant natural deposits other than those normally described by the phrase, "mines, oil and gas wells," as, for example, a sodium sulphate deposit (see *Ozark Chemical Co.* v. *Jones, supra*) or a gravel pit or a stone quarry (see *Parker Gravel Co.* v. *Commissioner,* 21 B. T. A. 51; *Dunn & Baker, Inc.* v. *Commissioner,* 30 B. T. A. 663). In any event, it is clear from the use of the words "other natural deposits" that the words preceding them, *i. e.,* "mines, oil and gas wells," were used only to refer to natural deposits of minerals, oil and gas in the earth. The plain fact of the matter is that the dumps in question were placed there by man and not by nature.

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[2] This was the issue involved in *Eggborn* v. *Smith*, 114 Va. 745, 77 S. E. 593, which is cited in 50 Corpus Juris 769, as authority for the statement that "severed rock deposited upon another's land and permitted to remain becomes real property."

The contention that the metal was naturally in place in the rocks in question and therefore constituted a "natural deposit" within the meaning of Section 23(m) is patently erroneous. If this were true, then the tailings deposit involved in the *Atlas* case, *supra,* would have come within the section, for it is equally true with respect to tailings that such metal as is present is a "natural deposit" in the sense that the metal came to be there as the result of natural forces and had not yet been removed by man. Moreover, it follows from the taxpayer's contention that these rocks would have been mines or natural deposits if they had been sold at the point of removal from the earth to a third party. Under the taxpayer's theory the purchaser would be engaged in mining when he undertook the separation of the metal from the rock. That the theory is erroneous is apparent from *Helvering* v. *Bankline Oil Co.,* 303 U. S. 362. There the taxpayer owned casing-head gas contracts under which it operated a plant for separating natural or "wet" gas into its component parts, gasoline and dry gas. Under the contracts the natural gas was taken by the taxpayer at the mouth of the wells and it was required to install and maintain the necessary pipe lines from the wells to its plants. The court held that the taxpayer was a processor and had no depletable interest in the gas, stating that (p. 368):

> The controlling fact is that respondent had no interest in the gas in place. Respondent had no capital investment in the mineral deposit which suffered depletion and is not entitled to the statutory allowance.

This principle is dispositive of the instant case for here also the taxpayer had no investment in the minerals in place or in the land from which they came. The properties which suffered depletion were the neighboring mines from which the ore had been extracted.

The underlying principle upon which the depletion deduction is based was stated by the Supreme Court in *Anderson* v. *Helvering,* 310 U. S. 404, 408, as follows:

> The deduction is therefore permitted as an act of grace and is intended as compensation for the capital assets consumed in the production of income through the severance of the minerals. *Helvering* v. *Bankline Oil Co.,* 303 U. S. 362, 366–367. The granting of an arbitrary deduction, in the interests of convenience, of a percentage of the gross income derived from the severance of oil and gas, merely emphasizes the underlying theory of the allowance as a tax-free return of the capital consumed in the production of gross income through severance. *Helvering* v. *Twin Bell Oil Syndicate,* 293 U. S. 312, 321; *United States* v. *Dakota-Montana Oil Co.,* 288 U. S. 459, 467.

The emphasis throughout the foregoing quotation is upon the severance of part of the substance of the property as the basis for the depletion allowance. In the instant case, the ore bearing rocks from which the taxpayer extracted gold did not come from mines located on its property but from mines located on adjacent properties. The severance was from the neighboring properties and it was those properties which were depleted by the extraction of the ore.

We submit that the instant case does not come within the plain meaning of the words of the statutory provisions permitting the deduction, nor of the principle underlying them. With respect to the dumps in question the taxpayer was not engaged in mining but in processing. The Commissioner and the Board have therefore properly denied the claimed deductions.

CONCLUSION

The decision of the Board of Tax Appeals should be affirmed.

Respectfully submitted.

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November, 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(4) *Percentage depletion for coal and metal mines and sulphur.*—The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 15 per centum, and, in the case of sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the

property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property. A taxpayer making his first return under this title in respect of a property shall state whether he elects to have the depletion allowance for such property for the taxable year for which the return is made computed with or without regard to percentage depletion, and the depletion allowance in respect of such property for such year shall be computed according to the election thus made. * * *

The corresponding provisions of the Revenue Act of 1938 are identical.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23(m)-1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under these provisions of the Act the owner of an interest in mineral deposits, mineral properties, or timber, whether freehold or leasehold, is allowed annual depletion and depreciation deductions which, in the aggregate, will return to him the cost or other basis of such property as provided in section 113, plus, in either case, subsequent allowable capital additions (see articles 23(m)-15 and 23(m)-16) with the following exceptions and qualifications:

* * * * *

When used in these articles (23(m)-1 to 23(m)-28) covering depletion and depreciation—

* * * * *

(*b*) A "mineral property" is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(*c*) A "mineral deposit" refers to minerals only, such as the ores only in the case of a mine, to the oil only in the case of an oil well, and to the gas only in the case of a gas well, and to the oil and gas in the case of a well producing both oil and gas. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

*   *   *   *   *

The corresponding provisions of Treasury Regulations 101, as originally promulgated under the Revenue Act of 1938, are the same. T. D. 4960, 1940–1 Cum. Bull. 38, 39, made the following amendments to Treasury Regulations 101:

> Regulations 101 [Part 9, Title 26, Code of Federal Regulations, 1939 Sup.], as made applicable to the Internal Revenue Code by Treasury Decision 4885, approved February 11, 1939 [C. B. 1939–1 (Part 1), 396] [Part 465, Subpart B of such Title 26], in so far as they prescribe rules relative to the allowance of depletion and depreciation deductions under sections 23(m) and 114 of the Internal Revenue Code, are hereby amended as follows:
>
> (1) The second, third, and fourth paragraphs of article 23(m)–1 [section 9.23(m)–1] are amended to read as follows:
>
> Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by invest-

ment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

The adjusted basis of depreciable property is returnable through annual depreciation deductions. Depreciation and depletion deductions on the property of a corporation are allowed to the corporation and not to its shareholders. (But see article 115–6 [section 9.115–6].) The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion. (See article 23(l)–1 [section 9.23(l)–1].)

(2) The first sentence of article 23(m)–1(*c*) [section 9.23(m)–1(*c*)] is amended to read as follows:

The term "mineral deposit" refers to minerals in place.

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